



DEPARTMENT OF ECONOMICS

April 7, 1998

Hon. John M. McHugh, Chairman  
Subcommittee on the Postal Service  
B-349C Rayburn House Office Bldg.  
Washington, DC 20515

Dear Chairman McHugh:

Thank you for your invitation to submit my comments and reactions to the proposed revisions to H.R. 22. I am enclosing my comments in both hard copy and disk form, in accordance with your request dated February 27, 1998.

Sincerely,

John Kwoka  
Professor of Economics

## Comments on Revisions to H.R. 22

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April, 1998

I find myself in agreement with much of what is proposed in the way of revisions. I note those areas of agreement and comment more fully on issues

### ***Section 3701(a)--Baseline Rates and Fees***

This section provides for an omnibus rate case designed to establish baseline rates. I have previously expressed the concern that such a proceeding would not simply be one more rate case. Rather, since its determinations would establish rates for some time to come, it might become a large and contentious proceeding. While I continue to have that concern, I also appreciate the need for satisfactory initial rates. Thus, to the extent that many--or at least many important--current rates are seen as inappropriate, an omnibus rate case may well be required.

Separately, I concur with the elimination of the provision for contingencies as fundamentally inconsistent with price caps.

### ***Section 3701(c)--Factors Determining Rates***

This section reverts to the initial list of factors determining rates in the omnibus rate case. If the omnibus rate case is to play an important role in correctly initializing rates, however, I would favor the revised list of determinants--that is, costs, demand, and quality--over the enumeration in the current statute.

### ***Section 3721--Formula Adjustment Factors***

The revision proposes use of CPI rather than GDPPI in the price cap formula. I strongly favor GDPPI. It is superior to CPI for these purposes for several reasons:

(a) GDPPI is a broader measure of inflation. It covers the entire domestic economy, whereas CPI reflects prices only in the urban household consumer sector. With its heavy emphasis on such things as housing prices, food, and entertainment, CPI cannot accurately predict input cost inflation for an enterprise like the Postal Service.

I might add that cited testimony to the effect that GDPPI "represent[s] only about one-third of the economy covering sales for final consumption" is incorrect: GDPPI covers all economic activity and transactions. It is the CPI that is restricted to final consumer sales.

(b) There are dozens of jurisdictions in this country that have used GDPPI for price caps in telecommunications and in electric power for as much as ten years. Experience with GDPPI has been favorable.

(c) The choice between CPI and GDPPI is quantitatively

important. Due to its heavy consumer goods emphasis, including such things as relatively volatile food prices, CPI rises faster than GDPPI and is more variable from year to year. Those are not desirable attributes.

Separately, I would agree completely that contriving new price indexes or ad hoc combinations of existing indexes is an undesirable basis for formula pricing for the Postal Service.

#### *Section 3722(a)--Maximum Rates*

I would note one technical matter concerning the procedures for setting maximum allowable rates. As specified, the maximum rate equals "the actual rate times the percentage change in GDPPI for that year, adjusted by the adjustment factor." This formulation does not appear to allow for banking unused pricing discretion, since any such unused discretion--by definition not part of current actual rates--would therefore not be factored in to next year's maximum rates.

I had previously suggested, and now restate my recommendation, that one index of maximum rates and another for actual rates be calculated. Any difference between the two would automatically constitute unused, or banked, pricing discretion. If two indexes are not to be employed, the language in this section would appear to need clarification to allow for banking.

#### *Section 3723(b)--Hearing Process*

I concur with the proposed hearing process for reviewing adjustment factors. I would also recommend that this same process be authorized to consider any necessary modifications to service baskets, pricing bands, and other design features of the price cap plan.

#### *Section 3723(c)--Adjustment Factors*

I concur with the linking of the adjustment factor to productivity. I concur with the proposition that it is expected that the factor will be negative, indicating a faster productivity increase, except under the most extraordinary and unexpected circumstances. I would recommend that the criteria for the latter exception--"honest, efficient, and economical management"--be strengthened to include "best practice." I concur that this determination be vested solely with the PRC.

I have previously expressed misgivings about setting different adjustment factors for each basket. I reiterate those concerns now. If the possibility of different factors is to be preserved, however, I would recommend that there be a stated presumption in favor of equal adjustment factors. This presumption could be rebutted only by clear and convincing of likely significant differences among the baskets. I would hope this would restrict such cases to instances where the inquiries and inevitable disputes are worthwhile.

Finally, I concur with the revision that avoids hardwiring the adjustment factor into the statute. The revision would allow an appropriate measure of discretion to the PRC.

#### *Section 3723(f)--Financial Exigency*

I concur with the more stringent requirements of the revision governing circumstance under which the Postal Service can request financial relief from the price cap plan during the 5-year cycle. If price caps are to succeed in modifying the behavior of a non-private enterprise, the expectations of management must be that they have extremely limited opportunity to avoid any adverse financial consequences of its actions.

#### *Section 3724--Review of Decisions*

I concur that Board decisions should be subject to judicial and administrative review. A necessary corollary to granting pricing discretion to an enterprise should be that its decisions are then subject to the same review as those of firms similarly situated or firms with which that enterprise competes.

#### *Section 3724(f)--Minimum Rates; Averaging*

I concur with the standard that rates for noncompetitive services must cover attributable costs. I would also urge that it be made quite clear that attributable costs are a minimum requirement--a "floor"--rather than a "safe harbor." Economics recognizes circumstances under which prices above attributable costs may nonetheless be anticompetitive.

I concur with rate averaging within baskets 2, 3, and 4. I also concur with the use of pricing bands on annual changes in individual rates, although I would recommend bands wider than 2 percent. The exact number is difficult to assign, especially initially, but a 2 percent rate change may restrict pricing discretion more sharply than circumstances warrant.

#### *Section 3742--Rate Criteria*

I concur with the proposition that a postal rate must cover attributable costs. I also concur that competitive products must in some sense collectively cover some institutional costs, but making the appropriate standard operational is challenging. The stated requirement that they bear institutional costs in at least the same proportion as noncompetitive services will create some distortions, but may have advantages in terms of practicality.

The third criterion allows revenue shortfalls on competitive products to be carried forward and recovered in some future year. Treatment of shortfalls on either competitive or noncompetitive products presents significant issues. In this case, some provision for shortfalls may be necessary but the carryforward permission would appear to invite temporary "targeting" of rivals. Current losses could simply be made up by future excess returns when the targeted rivals yield competitive ground. I would urge at a minimum that some further penalty be exacted in the case of shortfalls--perhaps interest payments on the carryforward losses, or even salary reductions or escrows applied to senior management.

#### *Section 3743--Product Transfers*

I concur with the reliance upon administrative procedures for transferring products between baskets based on their changing competitive characteristics. I would recommend that the language

offered as criteria be modified as follows: Where it now reads "...without risk of losing business to other firms offering similar postal services," I would replace "similar postal" with "substitute." My reasoning is that "similar postal" limits the substitution at issue to one category of providers of substitute services, whereas loss of business to nonpostal services--fax, internet, etc--should also be considered.

Also, the same language focuses on products where the Postal Service can "set the price...substantially above costs or raise prices significantly" [emphasis added]. I would inquire whether the difference in underlined phraseology is intended, and if so, whether the chosen terms accomplish that intention.

#### *Section 3744--Antitrust Application*

I concur with application of the antitrust laws to Postal Service pricing and other conduct.

#### *Section 3761--Market Tests*

I concur with the general thrust of the market test guidelines. I would urge consideration of allowing the PRC to alter the revenue guidelines or time guidelines as necessary, or to disallow "sham" tests or repeated tests designed to target rivals products.

#### *Section 3782--Use of Profits*

I concur with the language describing and limiting use of Postal Service profits.

### ADDITIONS AND ADDENDUM

#### *Postal vs. Non-postal Products*

The proposed revision would allow the Postal Service to offer non-postal products through a private and separate corporation. I would question the merits of such an allowance for three reasons:

(a) Despite the requirement of separate subsidiaries, such undertakings inevitably complicate regulatory and administrative task and provide opportunities for competitive abuse.

(b) The strict separation required to minimize distortions and abuses simultaneously limits if not eliminates opportunities for synergies between services.

(c) Experience with such arrangements in other industries has not been especially favorable. In addition to other concerns, these devices tend to distract management from their more fundamental obligations to core services.

#### *Service Quality*

There is no explicit mechanism for ensuring service quality in H.R. 22 or this revision. Since price caps raise well-known risks to quality relative to cost-of-service regulation, I would urge that the statute make explicit that:

(a) The Postal Service has an obligation to provide service or high quality and reliability.

(b) Service quality has specific dimensions (some of which ought to be enumerated) that will be monitored.

(c) The Postal Service will be required to provide regular and frequent monitoring reports on all these quality dimensions.